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TAGS: ECON ENRG EINV ETRD EFIN PREL CH
SUBJECT: CHINESE STEEL FIRM MAY BID $200 BILLION FOR MINING
GIANT RIO TINTO

Classified By: Econ M/C Rob Luke: Reasons: 1.4 (b/d)

SUMMARY

¶1. (C) China's top steel maker, Baosteel, is considering a $200 billion bid for Rio Tinto, the UK-based mining giant currently targeted in a $134 billion offer from Australian mining firm BHP Billiton. Rio is among a handful of Western firms that dominate trade in the increasingly expensive iron ore that China needs as the world's largest steel producer. Any move to acquire Rio would likely spark political controversy in numerous countries -- especially Australia and the UK -- at a time when China's new sovereign wealth fund is promoting itself as a responsible new actor on the financial world stage. A well-connected economist contact assesses it would take strong central government backing and coordination for there to be further movement in putting forward a bid. In the mean time, rumors about plans for Rio will make it more difficult for Australia's BHP to continue its own takeover efforts -- and anything that prevents a BHP-Rio tie-up is likely to be seen by China as in its own economic interest. The Financial Times reported that "senior executives of China's largest energy and mineral companies are understood to have held talks on the fringes of (China's annual high-level Central Economic Work Conference) about how to respond to a possible BHP/Rio merger." END SUMMARY

THINKING ABOUT A $200 BILLION SPLURGE

¶2. (U) Xu Lejiang, Chairman of Baosteel, China's largest steel maker, told Chinese media on December 4 that his firm is considering a bid for Rio Tinto, the UK-based mining giant currently targeted in a $134 billion offer from Australian mining firm BHP Billiton. Xu suggested that Baosteel would have to offer over $200 billion, which would make this the largest corporate takeover in history (eclipsing Vodafone's $190 billion takeover of Mannesmann in 2000). Separately, the Financial Times reported that "senior executives of China's largest energy and mineral companies are understood to have held talks on the fringes of (China's annual high-level Central Economic Work Conference) about how to respond to a possible BHP/Rio merger."

VIEWS OF A CONNECTED ECONOMIST

¶3. (C) Standard Chartered's Senior China Economist Stephen Green routinely talks to Chinese Government officials involved in investment issues. He told us that the China Investment Corporation has been resisting a bid for Rio and lacks sufficient financing. (Note: The CIC was recently formed using $200 billion of foreign exchange reserves. Most of these initial funds are being used for activities related to the domestic banking system, and the CIC appears to be moving slowly as it gears up to make investments abroad. The most notable investment to date has been a $3 billion stake in Blackstone. End Note.) Green noted Baosteel's low profits (for its listed division), implying that this casts doubt on the firm's ability to make such a play. In Green's view, "the State Council would have to bang a lot of heads and then involve the China Development Bank in financing an offer, perhaps off a special bond issue," to take a bid for Rio forward. Green speculated that Baosteel is probably also looking for offshore partners to spoil the BHP-Rio bid.

OTHER CHALLENGES TO A CHINESE BID

¶4. (C) China's steel makers do not have a history of acting in concert. It has required central government intervention to get them to negotiate in tandem with the big three iron ore "cartel" over the past couple of years. Price negotiations in 2006 ran several months longer than expected, and in 2007 it was widely rumored that several steel enterprises signed interim side-deals with iron ore producers before official price negotiations concluded. Also of note,

for Beijing to pursue a hostile takeover of Rio using government resources would likely be politically sensitive for numerous countries, both those with large steel sectors (e.g., Korea, India) and those which house the major mining companies (especially Australia, where much of Rio's iron ore is located, and the UK, where Rio is headquartered).

WHY CHINA CARES SO MUCH

¶5. (C) Western firms may be losing their relative position to state-owned firms in the global oil business, but in mining and other commodities, the situation is different. Mining resources are concentrated in countries like Australia and Canada, and widely controlled by the world's top four mining companies: BHP (Australia), Rio Tinto (UK), CVRD (Brazil) and Anglo American (UK). BHP, Rio, and CVRD control 75 percent of the international trade in iron ore and are major players in copper and coal (also important to China) as well. China's own resource companies remain small in volume by comparison.

LOOKING ABROAD FOR IRON ORE SUPPLIES

¶6. (U) China is now the world's leading steel producer, with a production capacity greater than 500 million metric tons. It is also the largest producer and consumer of iron ore, the primary raw input needed to make steel. China's domestic iron ore supply is of very low quality, its mining industry highly fragmented, and the infrastructure needed to move this resource to market overstretched. This has led to a reliance on imports to meet around half of the country's iron ore needs in 2007. More than 40 percent of China's 370 million metric tons of iron ore imports this year will come from BHP and Rio alone. Overseas mines owned by Chinese steel and mineral companies will only produce around 50 million metric tons of iron ore in 2007.

¶7. (C) China's leading steel enterprises are some of the country's largest consumers of imported iron ore. China's

flagship steel enterprise and rumored Rio takeover candidate, Baosteel, imports 90 percent of the iron ore it uses. Another influential Chinese steel enterprise, Beijing's Capital Steel, imports around 70 percent. These companies, together with Angang Steel and Wuhan Iron and Steel, formed a joint venture mining enterprise earlier this year to explore development of overseas iron ore resources. The company, Beijing Steel Industry United Mining Resources, has invested in a mining operation in Cambodia and is exploring investment options elsewhere, according to public statements from Chinese steel executives. Despite the headline grabbing formation of the new company, China's appetite for foreign company supplied imports will likely continue to grow. Overseas production of iron ore and other natural resources by Chinese companies so far is routinely sold abroad rather than sent back to China. Meanwhile, acquisition of Rio by a Chinese commercial entity would secure iron ore supplies and enable China to be more influential in future price negotiations with all firms.

FEELING IT WHERE IT HURTS THE MOST, THE WALLET
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¶8. (C) In 2005, iron ore producers raised prices by over 70 percent, and they are expected to boost them a further 25-50 percent next year, in the view of industry analysts. The China Iron and Steel Association (CISA) estimates that Chinese steel mills' raw material costs, including iron ore, have risen on average by 12 percent so far this year. This cost increase is being largely borne domestically since China consumes some 85-90 percent of the steel it produces. A BHP-Rio merger could put China's steel sector (and other commodity dependent sectors) at the mercy of a large privately-held corporation that might have an incentive to keep prices high over time -- or might at minimum not want to expand capacity too rapidly from an investment standpoint. Chinese firms that are direct competitors of BHP and Rio,

like state aluminum company Chalco, have also expressed concern.

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